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Revisiting the Temple of Loyalty

California Joan continues her battle to keep Meryl Terpitute from landing the firm in the ethical soup du jour

By ELLEN R. PECK

EDITOR'S NOTE: *This is the first of two MCLE self-study packages, each of which will earn one hour of MCLE credit in legal ethics. Part 2 will appear in the January 2000 issue of the California Bar Journal.*

California Joan, as the Firm's "ethics maven," was a member of the Firm's management team meeting to consider accepting new business. Meryl Terpitute, the Firm's biggest rainmaker, was also a member. His skating on the razor's edge of ethics threatened more than once to land him in the ethical soup du jour but kept California Joan busy and far from boredom.

After the arrival of the remainder of the management committee, Meryl raised the following situation:

"I have represented All Inclusive Insurance Company intermittently for 10 years. In late 1997, I prepared an opinion letter addressed to Big Insurance Company, in which I opined that Big and All Inclusive were jointly liable for the costs of defense and liability of Insured in litigation arising out of an automobile accident. I made a demand that Big share the costs of defense and contribute to any settlement, since liability was probable. Big declined to contribute to the defense of Insured or to the settlement of the litigation. All Inclusive told me not to take any further action and, by February 1998, I considered the file closed.

"In February 1998, Big retained me to represent the interests of another of its insureds, Manufacturer, in products liability litigation brought by Injured Child. That case is about to settle.

"In the meantime, All Inclusive has settled the case of Plaintiff v. Insured. All Inclusive desires the Firm to file a declaratory relief action against Big for contribution of its proportionate share of the costs of defense and settlement.

"Cali, a year ago you told me that the duty of loyalty to an independent subsidiary or constituent does not extend to the parent corporation, according to *Brooklyn Navy Yard Cogeneration Partners, L.P. v. Superior Court (The Parsons Corp.)* (1997) 60 Cal.App.4th 248. You said that the representation of a subsidiary did not necessarily create ethical duties to its parent corporation, precluding representation of adverse interests against the parent assuming that one was not the alter ego of the other. (Editor's Note: But see *Morrison Knudson Corp. v. Hancock, Rothert & Bunshoft, LLP* (1999) 69 Cal.App.4th 223, 81 Cal.Rptr.2d 425 enjoining a law firm's representation of parent's subsidiary's adversary while serving as "monitoring counsel" for parent's insurance underwriters regarding claims against parent, rejecting the utility of the "alter ego" test and adopting the "unity of interests" test for conflict purposes.)

"In the *Injured Child v. Manufacturer* litigation, I represent the defendant, a constituent of Big Insurance. So, the Firm does not have a conflict in suing Big on behalf of All Inclusive," Meryl ended.

"Meryl, were you Cumis counsel for Manufacturer?" asked California Joan.

"No," replied Meryl. "Big did not reserve its rights and there was no other conflict. The Firm is conflict free."

"Meryl, the conflict of interest analysis regarding the representation of an insured upon appointment by an insurance company is completely different from the corporate parent/subsidiary analysis. The Firm may be disqualified from representing All Inclusive if we accept this engagement at this time. A recent case, *State Farm Mutual Automobile Insurance Co. v. Federal Insurance Co.* (1999) 72 Cal.App.4th 1422, 86 Cal.Rptr.2d 20 disqualified a law firm from representing an insurance company in a declaratory relief action on identical facts," began Cali.

"But Big Insurance Company is not even our client!" interjected Meryl Terpitide.

"Cali, what did the case hold?" asked Managing Partner.

Cali responded:

"If an insurance company has issued no reservation of rights and has appointed a lawyer to represent the interests of its insured, the law presumes that a lawyer has a tripartite or 'triangular' attorney-client relationship. The lawyer is deemed to simultaneously represent both the insured as well as the insurer. Even though the insurer is frequently not a party to litigation, it is a real party at interest.

"Lawyers often have closer ties with the insurer than with the insured since the insurer characteristically engages and pays the attorney to defend the insured (*American Mut. Liab. Ins. Co. v. Superior Court*, (1974) 38 Cal.App.3d 579, 591, 113 Cal.Rptr. 561) and since it is customary for the insurer to control the defense it provides. (*Spindle v. Chubb/Pacific Indemnity Group* (1979) 89 Cal.App.3d 706, 714, 152 Cal.Rptr. 77).

"Courts have held that an insurance company is a client with respect to its ability to assert the attorney-client privilege under Evidence Code §954. (*American Mut. Liab. Ins. Co. v. Superior Court*, supra, 38 Cal.App.3d 579.)

"Moreover, an insurance company has an independent right, as a client, to bring a legal malpractice action against the counsel it hired to defend its insured. (*Unigard Ins. Group v. O'Flaherty & Belgum* (1995) 38 Cal.App.4th 1229, 1236-1237, 45 Cal.Rptr.2d 565; *American Casualty Co. v. O'Flaherty* (1997) 57 Cal.App. 4th 1070, 1076, 67 Cal.Rptr.2d 539.)

"An insurer that has retained counsel is entitled to expect counsel to fulfill a lawyer's professional duties counsel has undertaken to the insurer. (American Casualty Co. v. O'Flaherty, supra, 57 Cal.App.4th at p. 1076.) For these reasons, the case held that the attorney-client relationship between insurer and counsel appointed to defend its insured existed for conflict of interest purposes. (State Farm Mutual Automobile Insurance Co. v. Federal Insurance Co., supra, 72 Cal.App.4th at p. 1430.)"

Meryl Terpitute protested further.

"But these cases are not even related, and I have no confidential information from Big Insurance Company in the Injured Child v. Manufacturer case which is in any way relevant to All Inclusive v. Big Insurance Company case."

Cali then contrasted the duty of confidentiality employing the "substantial relationship test" with the duty of loyalty:

"Meryl, where a lawyer represents one client in a matter that is adverse to the interests of another current client, the primary value at stake is undivided loyalty. An aspect of the duty of loyalty is 'to protect the client in every possible way.' Even where the cases are unrelated and there is no danger of confidential information being used or disclosed, it is a violation of the duty of loyalty for the attorney to assume a position adverse or antagonistic to a client without the client's free and intelligent consent given after full knowledge of all the facts and circumstances. Automatic disqualification is the result. (State Farm Mutual Automobile Insurance Co. v. Federal Insurance Co., supra, 72 Cal.App.4th at p. 1431.)"

Meryl was thinking fast.

"Well, why can't we just accept the representation in All Inclusive Insurance v. Big Insurance Co. and take the risk? Big Insurance may make a demand for our recusal, which we can delay with correspondence saying we are looking into the potential conflict. In the meantime, I can settle the Manufacturer's case, making Big a former client. By the time Big brings a disqualification motion and the court rules on it, the loyalty issue will be moot since Big will not be our client, and since there is no substantial relationship between the two cases, the Court will have to let us continue representing All Inclusive."

"I just do not think that will work, Meryl. In State Farm Mutual Automobile Insurance Co. v. Federal Insurance Co., supra, 72 Cal.App.4th at pp.1432-1433, the law firm was disqualified even though the unrelated case had been settled before the disqualification motion was brought and heard," Cali replied.

"As you know, California has adopted the 'hot potato' rule, holding that it is a breach of the duty of loyalty to withdraw from the representation of a current client in order to accept representation of another more lucrative client that is adverse to the dropped client. (Truck Ins. Exchange v. Fireman's Fund Ins. Co. (1992) 6 Cal.App.4th 1050, 1057, 8 Cal.Rptr.2d 228.) These disqualification principles may well be applied to a lawyer who concludes representation by settlement of a case for less or more money than the case was worth in order to make a current client a former client and to accept representation adverse to that client. Additionally, we may run the risk of Big's malpractice claim that we settled the case for more money in order to conclude the case prematurely in order to accept representation of All Inclusive's case adverse to Big.

"There are two exceptions to the automatic disqualification rule in concurrent representation of adverse interest cases:

1. Upon discovery and absent consent, attorney immediately withdraws from an unseen concurrent adverse representation which occurred by 'mere happenstance.' (Truck Ins. Exchange v. Fireman's Fund Ins. Co., supra, 6 Cal.App.4th at p. 1058; Florida Ins. Guar. Ass'n, Inc. v. Carey Canada (S.D.Fla. 1990) 749 F.Supp. 255, 261.)

2. An attorney was permitted to withdraw as a means of escaping application of the per se disqualification rule where the concurrent representation arose as a result of an acquisition of the client by another company. However, for this exception to apply, it is critical that the attorney not have played any role in creating the conflict of interest. (Truck Ins. Exchange v. Fireman's Fund Ins. Co., supra, 6 Cal.App.4th at p. 1059; Gould, Inc. v. Mitsui Min. & Smelting Co. (N.D. Ohio 1990) 738 F.Supp. 1121.)

"State Farm Mutual Automobile Insurance Co. v. Federal Insurance Co., supra, 72 Cal.App.4th at p.1432 found that neither of these exceptions applied and observed, at pp. 1432-1433:

"' . . . [A]lthough this fortuitous settlement acted to sever McCor-mick's relationship with its pre-existing client, it did not remove the taint of a three-month concurrent representation. Consequently, the mandatory disqualification rule applies. [Citation omitted.]"

"Similarly, the facts in Meryl's proposed representation do not fit within the exceptions," concluded Cali.

"Isn't there a chance," Meryl went on, grasping at straws, "that Big Insurance Company may wait too long, not object to our representation and thereby impliedly waive our concurrent representation of All-Inclusive against them?"

"You have actually asked two questions: First, whether delay by the complaining party can defeat a disqualification motion, and, secondly, whether a client can impliedly consent to adverse representation.

"Gambling on either an opposing party's delay or implied consent is a high-risk venture for the following reasons:

"In successive representation situations, courts do recognize a narrow exception to the rules requiring disqualification based on delay. (River West, Inc. v. Nickel (1987) 188 Cal. App.3d 1297, 1309, 234 Cal.Rptr.33.)

"However, in order for the exception to apply, we would have to demonstrate (a) Big's unreasonable delay in bringing a disqualification motion which caused prejudice to our present client (Western Continental Operating Co. v. Natural Gas Corp. (1989) 212 Cal.App.3d 752, 763, 261 Cal.Rptr. 100); and (b) that the delay was 'extreme in terms of time and consequence.' (River West, Inc. v. Nickel, supra, 188 Cal.App.3d at p. 1311 - 'mere delay' in making a disqualification motion is not dispositive.) To my knowledge, no court has yet addressed whether a long, prejudicial and unreasonable delay in a 'duty of loyalty' disqualification matter will exempt the lawyer from disqualification.

"State Farm Mutual Automobile Insurance Co. v. Federal Insurance Co., supra, 72 Cal.App.4th at p.1434, held that delay was not a factor since within one month of the commencement of litigation, Federal notified opposing counsel of its objection to counsel's representation of State Farm.

"Implied consent to adverse representation by conduct other than delay is another possible defense to disqualification. (Health Maintenance Network v. Blue Cross of So. California (1988) 202 Cal.App.3d 1043, 1064, 249 Cal.Rptr. 220 —Attorney for Health Maintenance Network had previously represented Blue Cross; Blue Cross, in setting up Health Maintenance Network, had provided the attorney to act as Health Net's counsel, which was an implicit consent to any adverse representation which would not support disqualification.)

"However, *Blecher & Collins, P.C. v. Northwest Airlines, Inc.* (C.D.Cal. 1994) 858 F.Supp. 1442, observed that Health Maintenance Network's holding was limited to former client conflicts and that different standards apply to conflicts between current clients.

"Our case, like *State Farm Mutual Automobile Insurance Co. v. Federal Insurance Co.*, supra, 72 Cal.App.4th at p.1435, is completely different. Big Insurance Company will not be aware of our adverse representation until we take the hostile act of suing them. Therefore, unless Big delays for a long time or hires the Firm in another case to represent the interests of its insureds, we cannot assert any implied consent."

"I hate to turn All-Inclusive down," Meryl said dejectedly. "Well, Meryl, there is even more bad news: The court in dicta suggested that we should not have accepted Big's appointment to represent its insured, Manufacturer, since we knew that All-Inclusive's dispute with Big might result in further litigation and that our legal services might be required by All-Inclusive. (*State Farm Mutual Automobile Insurance Co. v. Federal Insurance Co.*, supra, 72 Cal.App.4th at p.1435.)"

"That's ridiculous!" cried Meryl. "The engagement was terminated by All-Inclusive, after Big declined to contribute to the litigation. How would I know that, some two years later, All-Inclusive would decide to bring a declaratory relief action or that it would hire me again to litigate the matter on its behalf?"

"Yes!" agreed Managing Partner. "How can we ever develop a conflict checking category which would flag potential litigation that is related to coverage work we have done, but in which we may never be hired as litigation counsel?"

"I do not think you can," responded Cali. "Because of the practical impossibility of predicting whether a client will hire a lawyer for another independent stage of a dispute, I hope that this particular dicta thread is not picked up and embellished by any other published opinion."

"My recommendation is that you do not accept this representation or give any advice to All Inclusive on that matter at this time. Once the *Injured Child v. Manufacturer* case is settled and our representation of Big Insurance is then terminated, nothing would preclude the Firm from accepting representation of All-Insurance against Big. You are still taking a risk that a court may extend the *State Farm v. Federal* case, but it is less likely that a court will want to look to the lawyers' parties' intent in settling a lawsuit to divine some ulterior motive to avoid a conflict," counseled Cali.

Once again, the Firm's management committee agreed with Cali's analysis and voted to decline the representation of All-Inclusive. On the way back to their offices, Cali counseled Meryl to simply advise All-Inclusive that the Firm was not available at the present time to accept representation of the declaratory relief action against Big Insurance Co.

After entering his office and closing the door, Meryl telephonically advised All-Inclusive that the Firm was not available at the present time to accept representation of the declaratory relief action against Big Insurance Co., but that he believed that the Firm would be available in about 30-45 days. Meryl then called Big Insurance Company's claims adjuster handling Injured Child v. Manufacturer and asked whether the settlement check had gone out to Injured Child's attorney yet.

Next month

Will Cali be able to keep Meryl Terpitute and the Firm safe from disqualification and fee disgorgement? Tune in next month for further adventures in conflicts of interest.

Ellen R. Peck is a former trial judge of the State Bar Court, State Bar of California (1989-1995), a former ethics counsel to the State Bar of California and the American Bar Association, the vice chair of the State Bar Committee on Professional Responsibility and Conduct and the immediate past chair of the Los Angeles County Bar Association's Professional Responsibility and Ethics Committee. She is a co-author of Vapnek, Tuft, Peck & Weiner (1997) "The Rutter Group California Practice Guide - Professional Responsibility."

Test — Legal Ethics

1 Hour MCLE Credit

This test will earn 1 hour of MCLE credit in Legal Ethics.

1. True/False. A lawyer's duty of loyalty to an independent subsidiary or constituent does not extend to the parent corporation absent a unity of interest or unless one is the alter ego of another.
2. True/False. A law firm which serves as "monitoring counsel" for Company's insurance underwriters regarding claims against Company may be enjoined from representing Adverse Party against Company if the claims are substantially related to the work performed as monitoring counsel.
3. True/False. The conflict of interest analysis regarding the representation of an insured upon appointment by an insurance company is identical to the corporate parent/subsidiary analysis.
4. True/False. If an insurance company has issued no reservation of rights and has appointed a lawyer to represent the interests of its insured, lawyer has no attorney-client relationship with the insurer.
5. True/False. Lawyers often have closer ties with the insurer than with the insured since the insurer characteristically engages and pays the attorney to defend the insured and since it is customary for the insurer to control the defense it provides.
6. True/False. When a lawyer is appointed to represent the interests of the insured, courts have prohibited insurance companies from asserting the attorney-client privilege under Evidence Code §954 as a client.
7. True/False. An insurance company has no standing to bring a legal malpractice action against the counsel it hired to defend its insured.
8. True/False. An insurer that has retained counsel to represent the interests of its insured is entitled to expect counsel to fulfill a lawyer's professional duties owed to the insurer as well.
9. True/False. In a successive attorney-client relationship case, the primary value at stake is confidentiality.
10. True/False. The "substantial relationship test" is applied whenever the duty of loyalty is the primary value within the conflict of interest analysis.
11. True/False. Where a lawyer represents one client in a matter that is adverse to the interests of another current client, the primary value at stake is undivided loyalty.

12. True/False. An aspect of the duty of undivided loyalty is "to protect the client in every possible way."
13. True/False. Even where the cases are unrelated and there is no danger of confidential information being used or disclosed, it is a violation of the duty of loyalty for the attorney to assume a position adverse or antagonistic to a client without the client's free and intelligent consent given after full knowledge of all the facts and circumstances.
14. True/False. If Lawyer's engagement for Client X terminates fortuitously after Lawyer files an action against Client X on behalf of ABC Corp. and before Client X moves to disqualify Lawyer, Lawyer will not be disqualified because the matter is moot.
15. True/False. California has adopted the "hot potato" rule, holding that it is a breach of the duty of loyalty to withdraw from the representation of a current client in order to accept representation of another more lucrative client that is adverse to the dropped client.
16. True/False. One exception to the automatic disqualification rule in concurrent representation of adverse interest cases is if, upon discovery and absent consent, a lawyer immediately withdraws from an unseen concurrent adverse representation which occurred by "mere happenstance."
17. True/False. An attorney has been permitted to withdraw as a means of escaping application of the per se disqualification rule where the concurrent representation arose as a result of an acquisition of the client by another company and where the lawyer played no role in creating the conflict of interest.
18. True/False. Unreasonable delay in bringing a motion for disqualification in a successive representation situation can prevent disqualification if the delay caused prejudice to the present client and if the delay was extreme in terms of time and consequence.
19. True/False. Implied consent to adverse representation by conduct other than delay is never a possible defense to disqualification in successive representation cases.
20. True/False. If implied consent is a defense to disqualification, it has never been a defense in a concurrent representation of adverse interests of current clients.

Certification

- This activity has been approved for Minimum Continuing Legal Education credit by the State Bar of California in the amount of 1 hour, of which 1 hour will apply to legal ethics.
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TEST #14 – Revisiting the Temple of Loyalty

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